EXHIBIT 433

Strategies for Combating Gray Market Activity

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With the value of gray market products sold throughout the world topping a billion dollars annually, exporters of manufactured goods can hardly afford to remain vulnerable to this phenomenon.

Have you ever wondered why everyone in a market is using your product, but your distributor in that market is only recording average throughput? Where are all of these products coming from? Unfortunately, they are often flowing through a channel over which you have very little control. This type of distribution is termed a *gray market*, or *parallel importing*, and activity within it is growing.

One example of how a firm discovered gray market distribution of its products is illustrated in the comments of a U.S. air compressor manufacturer we surveyed who exports to Germany:

> We noticed our sales numbers were stagnant in this particular market, when all other indicators showed that sales should have been increasing. We were suspicious that there might have been some unauthorized distribution of our product occurring, so we sent one of our engineers over [to the market] incognito with the specific task of trying to buy our compressors from as many distributors as possible. Now remember, we only have one authorized distributor in this market. Within a week our engineer calls the office, and informs us he has four identical compressors, all manufactured by us, each purchased from a different distributor. Obviously, three of these distributors weren't legally selling our product. Our engineer was able to buy the compressors for significantly lower prices from the three [unauthorized distributors], who were doing great business. Our distributor wasn't even a "major player."

In this case, compressors were trickling in from Denmark or Switzerland, where middlemen were not receiving "optimal" prices for their goods. The gray market activity had almost completely replaced the authorized distributor, thus leaving the manufacturer with very little control over any aspect of its product—a serious concern in a highly competitive marketplace.

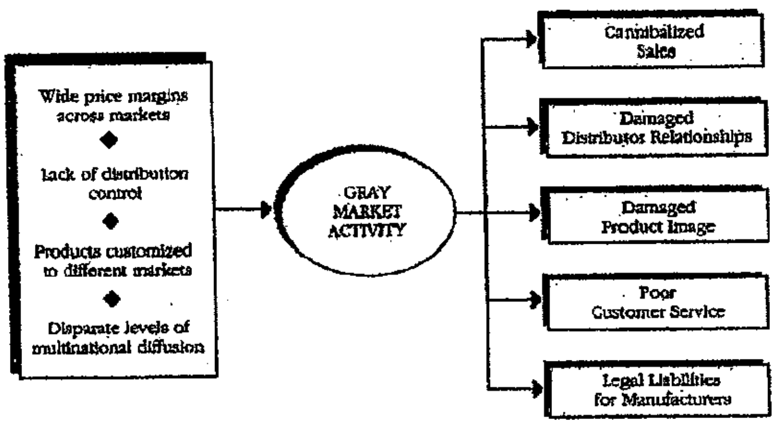
Gray markets occur when genuinely branded merchandise flows through unauthorized channels. This distribution often takes place across market borders, where environmental conditions are conducive to profits. Gray marketers are generally distributors that capitalize on price differentials via the purchase of goods in one market, either from an authorized dealer or directly from the manufacturer, and then re-sell the product in a higher-priced market at a profit. Unlike "black" markets, they are not necessarily globally illegal per se, although unauthorized distributors often transport products across borders without proper licenses or counter to governmental trade regulations. Recent legislation in the European Union (EU) has placed a ban on gray market activity, resulting in an increase in legal actions taken against retailers and importers dealing in the unauthorized distribution of goods.

Usually, however, gray market distribution is simply a form of arbitrage in which the beneficiaries are those individuals outside established supply-chain agreements. Consumer groups, says Auvil (1995), argue that gray markets promote competition and keep prices low due to competitive pressures. From the manufacturer's perspective, however, gray markets can impair the trade-

mark owner's ability to achieve a return on investment or protect brand image. Unfortunately, little is known about the markets and industries most vulnerable to parallel imports. Often, managers are unaware of gray market activity, or feel falsely secure because they have not directly observed gray market selling of their products.

As our survey of manufacturing exporters will show, this complacency is unwarranted. Gray market activity is a worldwide phenomenon occurring not only in lesser developed or volatile markets, but also in many markets that managers generally consider to be the safest and most stable in the world. In fact, gray marketing occurs in almost every manufacturing industry. Therefore, managers must set active strategies in place to minimize their vulnerability to such activity.

Figure 1
The Implementation Network



The Effects of Gray Markets on Export Operations

Traditionally, we see gray markets as being detrimental to all forms of cross-border exchange and to the bottom lines of internationally active firms. Although in most instances this is true, it should be noted that cases occur in which gray markets can actually benefit a company. According to Champion (1998), unauthorized distributors can aid a manufacturing firm by serving price-sensitive customers and other buyers who lie outside the reach of traditional channels. Similarly, some buyers desire products that are not packaged with expensive service agreements or warranties; they can purchase goods from unauthorized distributors for a lower price and indirectly increase the sales volume of the manufacturer. Typically, however, gray markets reduce a manufacturer's ability to control vital aspects of international marketing. This lack of control, says Myers (1999), can seriously affect the company's global performance outcomes.

The problems associated with gray market imports include pricing policies, distributor relationships, sales force morale, customer service, and the measurements used to evaluate employee performance. This means that the various functional areas within the firm often view the problem very differently. As **Figure 1** shows, these detrimental outcomes of gray marketing are often the result of both market and organizational factors, such as wide price margins between customers, lack of distribution control, and disparate levels of multinational diffusion and standardization of exports.

Five separate aspects of business have been identified as being detrimentally affected by parallel imports. The first, erosion of trademark image, occurs when the esteem at which products—especially prestige products—are held is reduced due to the "discounted" price at which unauthorized distributors sell them. Second, the relationships between manufacturers and dealers can become strained when profits go to unauthorized distributors rather than contracted middlemen. Third, legal liabilities can damage a manufacturer, because imports that are unauthorized are often not made to the import country's safety or local content specifications. Fourth, marketing strategy and profits can be disrupted as forecasting and pricing decisions become increasingly complex when sales and market data are inaccurate due to unknown distribution and sales patterns. Finally, unauthorized distributors do not always provide appropriate levels of product support and customer service, thereby damaging the reputation of the manufacturer.

Both active and reactive strategies can be instituted to combat gray market activity, and it is generally agreed that a well-managed export operation should take measures to prevent or reduce the ill effects caused by gray market competitors. Unfortunately, in many export markets, gray market activity is not always readily apparent; managers often believe that declining sales

Table 1
Regions, Markets, and Industries Affected by Gray Market Imports

Region	*Percent of Firms Reporting Gray Market Activity*	*Industries Affected Within Region*	*Country Market Having Most Gray Market Activity*	*Products Affected in Country with Most Gray Market Activity*
North America (including Mexico)	13%	Fabricated metal products; measuring, analyzing, and controlling equipment; durable goods	Mexico	Auxiliary lighting (autos), process controls and software, coaxial cable, microwave systems
Latin America	17%	Industrial and commercial machinery; measuring, analyzing, and controlling equipment; electronics; durable goods, fabricated metal products	Colombia	Industrial coatings, thread compounds, commercial refrigerators, fluid pumps and tanks
Middle East	5%	Industrial and commercial machinery		
Sub-Saharan Africa	1%	Industrial and commercial machinery		
Pacific Rim	27%	Rubber and plastics; industrial and commercial machinery; primary metals; fabricated metal products; durable goods	Japan	Cookware, compressors and pumps, pumping systems, machine tools, drill bits, specialty-cut plastics
Western Europe	27%	Industrial and commercial machinery; measuring, analyzing, and controlling equipment; electronics; durable goods; fabricated metal products; miscellaneous manufacturing; paper products, chemicals and allied products	Germany	Work platforms, boat hardware, pneumatic pumps, packaging equipment, firearms
			U.K.	Welding alloys, hand cleanser, dental care products, electronic ignition systems, conveyor belts
Scandinavia	3%	Industrial and commercial machinery		
Former Soviet Union	7%	Industrial and commercial machinery; electronics; measuring, analyzing, and controlling equipment; miscellaneous manufacturing	Russia	Earth-moving equipment, laboratory equipment, grain silos, glass-cutting equipment

and profit margins are the result of other competitive factors. Upon realizing the detrimental aspects of exporting gray market products, it is often too late to prevent the damage from occurring. Therefore, it is beneficial for managers to be aware of markets in which this activity occurs, and which industries are most vulnerable to it, before their export efforts are affected by unauthorized imports.

To better understand the prevalence of gray market activity, we surveyed a number of U.S.-based exporters. Our respondents were export managers, marketing managers, and international business directors who were responsible for managing the export sales. In all, we contacted 401 firms, of which 78, or almost 20 percent, identified their individual export markets and indicated that their export ventures were highly affected by gray market imports. The markets, industries, and products of these firms are characterized in **Table 1**. The country markets represented in Column 4 of the table are those identified as having a disproportionate frequency of gray market activity relative to the trade ratios in their regions. For example, Mexico receives less than half of U.S. North American Free Trade Agreement (NAFTA) exports, yet it represents 87 percent of unauthorized distribution in this region. Across the sample frame, the ratio of respondents active in particular markets or trade regions (shown in **Table 2**) did not differ significantly from Department of Commerce trade statistics.

The Prevalence of Gray Markets

As evidenced by Table 1, our survey results—some of which were surprising—indicate that a significant amount of gray market activity is occurring in a wide variety of markets around the world. We have broken down our results into

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eight export regions: North America, including Mexico; Latin America, which includes Central and South America and the Caribbean; the Middle East, including Iran; sub-Saharan Africa; the Pacific Rim, including Australia and New Zealand; Western Europe; Scandinavia; and all countries formerly comprising the Soviet Union, including the Central Asian Republics.

Column 1 of Table 1 shows that every major trading region was identified by exporters as experiencing gray market activity that was detrimental to their operations. The regional breakdown in this study follows the general lines of the Department of Commerce reports on import/export numbers across trading regions. An exception in the breakdown of Table 1 is the inclusion of Mexico in North America. This was done to better analyze the NAFTA nations together. An investigation of trade regions, followed by individual country markets, is worthwhile because most gray market activity occurs between adjacent or proximal nations.

Column 2 shows the number of exporters who stated that unauthorized distribution was a problem in those regions. Thirteen percent of the firms indicated gray market activity in North America. More than one-fourth of them indicated they were suffering from gray markets in both the Pacific Rim and Western Europe. Seventeen percent of the unauthorized imports were reported in Latin America. Seven percent were reported in the former Soviet Union, while the Middle East, Scandinavia, and sub-Saharan Africa recorded the lowest cases of gray market activity.

It is important to note again that the number of respondents operating in particular export regions does not differ significantly across markets or industries from the trade ratios offered by the Department of Commerce. However, the amount of gray market activity in several of these areas is disproportionate to the amount of export activity. For example, whereas Western Europe accounts for roughly 16 percent of U.S. manufacturing exports, 27 percent of the respondents complaining of gray marketing were exporters to Western Europe. Similarly, the Pacific Rim's gray market activity was disproportionately high relative to the number of exports it receives from U.S. manufacturers (27 percent versus 19 percent).

Industries with the Greatest Gray Market Threat

Results from our survey suggest that gray marketing is not restricted to lesser developed countries or volatile markets. Further, results indicate that whereas all products are susceptible to gray market activity, certain industries are particularly vulnerable in given export regions

Table 2
Descriptive Statistics for the Respondent Sample of Firms

	Mean	*Median*	*Standard Deviation*
International business experience (no. of years)	24.9	20	17.3
Number of export markets	24.4	15	26.1
Percentage of sales derived from exports	24.1	20	20.5
Total sales volume (in million US$)	85.3	24	180.0
Number of employees	601.1	210	1,366.4

In the NAFTA countries, gray markets were found in a wide variety of manufacturing industries (Table 1, Column 3). Exporters operating within the NAFTA framework may have fewer restrictions on shipping products across borders, but this has not alleviated the threat of unauthorized distribution of their products, especially in Mexico. Eighty-seven percent of firms indicating high unauthorized import activity in NAFTA markets identified Mexico as the country of import, versus 13 percent exporting to Canada—a ratio significantly out of proportion with those countries' import numbers from the United States. The product markets most vulnerable in Mexico were automobile auxiliary lighting, process controls and software, coaxial cable, and microwave systems. Multiple firms complained of gray markets in both automobile auxiliary lighting and process controls and software, indicating significant lack of distributor control with these products. And while Mexico was an area of frequent violations, one exporter noted that its stainless steel rods and wires were constantly affected by gray marketing in Canada, a market that many managers do not associate with such a threat.

In Latin America, industrial and commercial machinery, measuring, analyzing, and controlling equipment, electronics, durable goods, and fabricated metal products exported from the U.S. were the most vulnerable to gray market activity (Table 1, Column 3). Most notably, in the Latin American trading region, Colombia was the only country mentioned several times. Here, gray markets exist for industrial coatings, thread compounds, commercial refrigerators, pumps, and fluid tanks. Perhaps this is not too surprising to exporters familiar with business practices in Colombia. One manager explained, "We knew what we were getting into when we started exporting there, and considered dealing with gray market activity part of the price of doing business in that country."

In the Pacific Rim, a variety of rubber, plastic, and metal industries were reported to be highly vulnerable to gray marketing. It is interesting to note that these industries were identified as problematic only in the Pacific Rim and not in any other trade region, despite the fact that they are exported to each. Even more interesting is the

fact that Japan was the subject of more complaints than either Hong Kong or mainland China, two markets famous for unauthorized or illegal distribution of software and entertainment products. Exporters maintained that the sales of compressors and pumps, cookware, machine tools, drill bits, and specialty-cut plastics were all affected by unauthorized distribution. In the case of the plastics exporter, no amount of remonstration to Japanese officials had alleviated this problem over the previous year.

Western Europe, often considered one of the areas least vulnerable to gray market activity, had the largest variety of industries affected: industrial and commercial machinery; measuring, analyzing, and controlling equipment; electronics; durable goods; fabricated metal products; miscellaneous manufacturing; paper products; and chemicals and allied products. This surprising array of industries is somewhat disconcerting considering the stable reputation Western Europe has among many exporters and multinationals. Most surprisingly, Germany, often considered to be the most stable economy (and thus the safest from gray markets) in Western Europe, was reported to have the greatest amount of gray market activity. In particular, pneumatic pumps, packaging equipment, firearms, and other products were found to be most vulnerable to unauthorized distribution.

In the former Soviet Union, parallel imports were reported in industrial and commercial machinery, electronics, and measuring, analyzing, and controlling equipment. Of the former Soviet republics, Russia has become a particular problem, specifically in earth-moving, laboratory, and glass-cutting equipment.

Our study received responses from a number of exporters whose primary markets were in the Middle East, Scandinavia, and sub-Saharan Africa. The majority of these exporters did not indicate that they had been affected by any gray market activity, and their products' industrial classifications included all manufacturing categories. As indicated in the table, the only industry classification that was identified as affected was industrial and commercial machinery, and this only to a limited extent with a low number of instances reported.

Although our study provides a synopsis of gray market activity, it should not be seen as a comprehensive review of the subject throughout the world. Gray marketing occurs in almost every industry and in almost every market. If organizations are to protect themselves, an active set of strategies must be put into place.

Figure 2
Strategies for Combating Gray Market Activity

- Coordinate your distribution channel horizontally.
- Stay apprised of changing regulations.
- Pay attention to differentiated products across markets.
- Restrict the autonomy to set prices.
- Stay in touch with your distributors.

Combating Gray Market Activity

With the growing emphasis on distribution efficiency as a competitive competency, the role of export managers has grown within organizations, and with it the responsibility of effectively controlling product distribution across borders. As we have seen, the problems associated with this control are often augmented by operating in multiple economic and regulatory environments. Moreover, the effective management of export distribution channels often relies on a company's ability to combat gray market activity and restrict unauthorized "leakage" from its supply chain operations. To do this, managers must realize that gray markets are not the other guy's problem, nor are they restricted to volatile economic environments in exotic third-world locales.

Fortunately, advances in information technology have given manufacturers an opportunity to capitalize on information capturing and processing capabilities to identify and forecast gray market activity. Most manufacturers process an enormous amount of information pertaining to the distribution of their products: prices, shipment quantities, product specifications, and so on. Most of this information is maintained in their internal databases. Advances in information technology, such as the World Wide Web, now allow manufacturers to capitalize on their internal databases through information dissemination to their distributors. What is suggested is the use of a Web-accessible database offering the manufacturer and its distributors both input and review of information that may be critical to monitoring and forecasting gray market activity.

Several strategies that can capitalize on advances in information technology are available to managers for combating the gray markets (see **Figure 2**). Specifically, managers may reduce the damage by using technology to concentrate on a few key areas of their distribution efforts:

• **Coordinate your distribution channel horizontally.** A key aspect of minimizing the potential of gray market activity that is often overlooked by management is the coordination of the distribution channels across markets. Although management may already take an active approach to coordinating channels from headquarters, possibly even contemplating channel inte-

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gration, another aspect to consider is "horizontal" coordination. Gray marketing occurs when products cross borders. Legitimately branded products are most likely distributed through an authorized distributor within one market either knowingly or unknowingly, and then transferred across the border. Horizontal coordination enhances the distribution of information across distributors.

By making the database available to all distributors, those in one market have easy access to those in other markets. Thus, if one distributor notices a sharp increase in sales to unfamiliar customers, it can alert both the manufacturer and the distributors in a geographically close market to which the product may flow, thereby "flagging" potential problems. The database can also serve as a means of stimulating communication among distributors across markets. Increased distributor communication can result in sharing "best practice strategies" across markets, which creates a more effective distribution network.

• **Stay apprised of changing regulations.** Environmental variables lying outside the control of exporters include the import/export regulations imposed by individual markets. Export price escalation can occur when governments place high tariffs on imported goods, increasing the landed price of the product and forming price margins between countries. An example of this occurred when the EU taxed nonmember imports, then subsequently accepted nations into the realm of the trade agreement. This caused price differentials between the member and nonmember markets, which is evident in the examples provided by our respondents. Nonmember nations have different status with the EU, and therefore different tax and tariff burdens, so their exports to the region bear disparate price escalation pressures. In addition, porous borders such as that between Venezuela and Colombia provide a greater degree of gray market opportunities than do more restrictive boundaries.

Who is more familiar with such changing regulations than the distributors in the marketplace? By allowing distributors to input changes in their individual market environments into the organizational database, manufacturers can stay apprised of changing regulations and thus better monitor and forecast areas of potential gray market activity. Using a Web-accessible database can also allow distributors to monitor changing regulations in geographically proximal markets that may be affecting their business. In all, distributor input of changing conditions will not only enhance the forecasting and identification of gray markets, but it will also offer the manufacturer a better understanding of its worldwide markets.

• **Pay attention to differentiated products across markets.** This is particularly true at the retail product level, where consumer preferences vary with colors, sizes, and other product attributes. However, differentiated industrial products are also quite vulnerable. Gray markets sometimes develop when regulations restrict or prohibit certain types of product modifications or enhancements in particular markets (such as with chemical products or emission control systems). The marketers take advantage of these discrepancies to ship products to other buyers. Although it is difficult to customize products to the exact demands of each market, wide varieties of the same types of products across markets often lead buyers to search out distributors who will offer the desired product variable. This opens the door to gray marketing.

By including product reports and tracking product service records, the Web-accessible database will again allow manufacturers and distributors to monitor gray market activity. Companies can identify specific product attributes that may be contributing to gray marketing in local markets. They can then use this information either to make product modifications in the current market (within the product specifications required by that government), or to provide supportive evidence to the government for a necessary change in product standard policy.

• **Restrict the autonomy to set prices.** Many manufacturers today are providing their salespeople and lower-level managers with the discretion to set prices for individual customers. This allows firms to respond quickly to competitive sales pressures and meet customer demands. Unfortunately, it also leads to wide price margins across country markets, especially when separate managers are responsible for different geographic locales. Often, middle- and upper-level managers are the only individuals familiar with both volatile underlying product costs and varying economic/currency conditions across markets—two factors influential in creating wide price margins.

Collecting and disseminating pricing information across markets will give manufacturers and distributors vital information on price competition in world markets. That information can be used by manufacturers to set pricing parameters within geographic regions to minimize gray market activity. While centralized price controls in the past were often viewed by distributors as dictates, the free flow of information offered by the Web-accessible database will provide distributors with firsthand knowledge of cross-market prices, thereby providing a rationale for establishing the pricing parameters.

• **Stay in touch with your distributors.** Distributor arrangements are usually contracted, so many exporters have a tendency to discuss distribution arrangements with their middlemen only once or twice a year. There is no question that increasing communications between a manu-

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facturer and its distributors can enhance the overall relationship and help combat gray markets.

A Web-based database can also serve as the foundation for a discussion community regarding issues relevant to the distribution and service of the manufacturer's product. More frequent contact with authorized distributors through such an interface will assist manufacturers in understanding distributor concerns regarding a variety of issues. Increased communication will undoubtedly lead to a better understanding of the distributors' market environment and end users.

After the Fact—Some Legal Alternatives

Despite these techniques for actively combating gray market activity, it is evident that most managers fail to address unauthorized distribution problems until after discovering some sort of channel leakage. If this is the case, a number of legal measures should be investigated. If the problem is occurring inside the United States, the U.S. Customs Service is authorized by statute to issue regulations preventing the importation of offending goods (Section 526 of the Tariff Act). However, there are some important exceptions to this law of which managers should be aware.

Those goods entering the market that are owned by affiliated companies are considered non-infringing goods and are not illegal. So interfirm agreements and strategic alliances can influence the ability of managers to apply customs protection. In Europe, authorized distributors can approach the EC, which has recently taken stringent action against gray markets by levying a number of "cease and desist" orders against retailers selling trademark goods without manufacturer approval. Levi-Strauss and Guess? Inc. took this route by bringing action against Britain's largest supermarket chain, Tesco.

Of course, successful pursuit of specific legal measures to counter gray market activity depends in large part on the local environment. In many markets, particularly in developing economies, the means with which to pursue legal prevention of unauthorized imports is limited. Thus, the importance of actively seeking measures to reduce parallel imports becomes ever more apparent. Manufacturers always have the option of punishing contracted middlemen who are distributing outside their authorized markets, but this would rely on an accurate assessment of the distributor's behavior and the means with which to modify that behavior through incentives or penalties.

Manufacturers cannot afford to be complacent about gray market activity in world markets. The results of our survey indicate that this problem thrives in markets all around the world. Whether in a stable market such as the United Kingdom or Germany, or a relatively volatile market such as Colombia or Mexico, most industries are vulnerable to the phenomenon. Nevertheless, despite the tremendous amount of gray market activity going on in the global marketplace, few firms have instituted strategies to minimize that vulnerability.

Fortunately, advances in technology have given manufacturers a new weapon for combating the threat. Through the development of a Web-accessible database, companies may be able to achieve new efficiencies in monitoring and forecasting gray market activity. The five key combat strategies we have offered can be integrated into such a database to provide companies with a competitive competency in distribution efficiency as they enter the new millennium. ☐

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